Development of Modern Pay Practices

UCLA

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Anderson & Public Policy

Fiat Lux Seminar, 11/18/05

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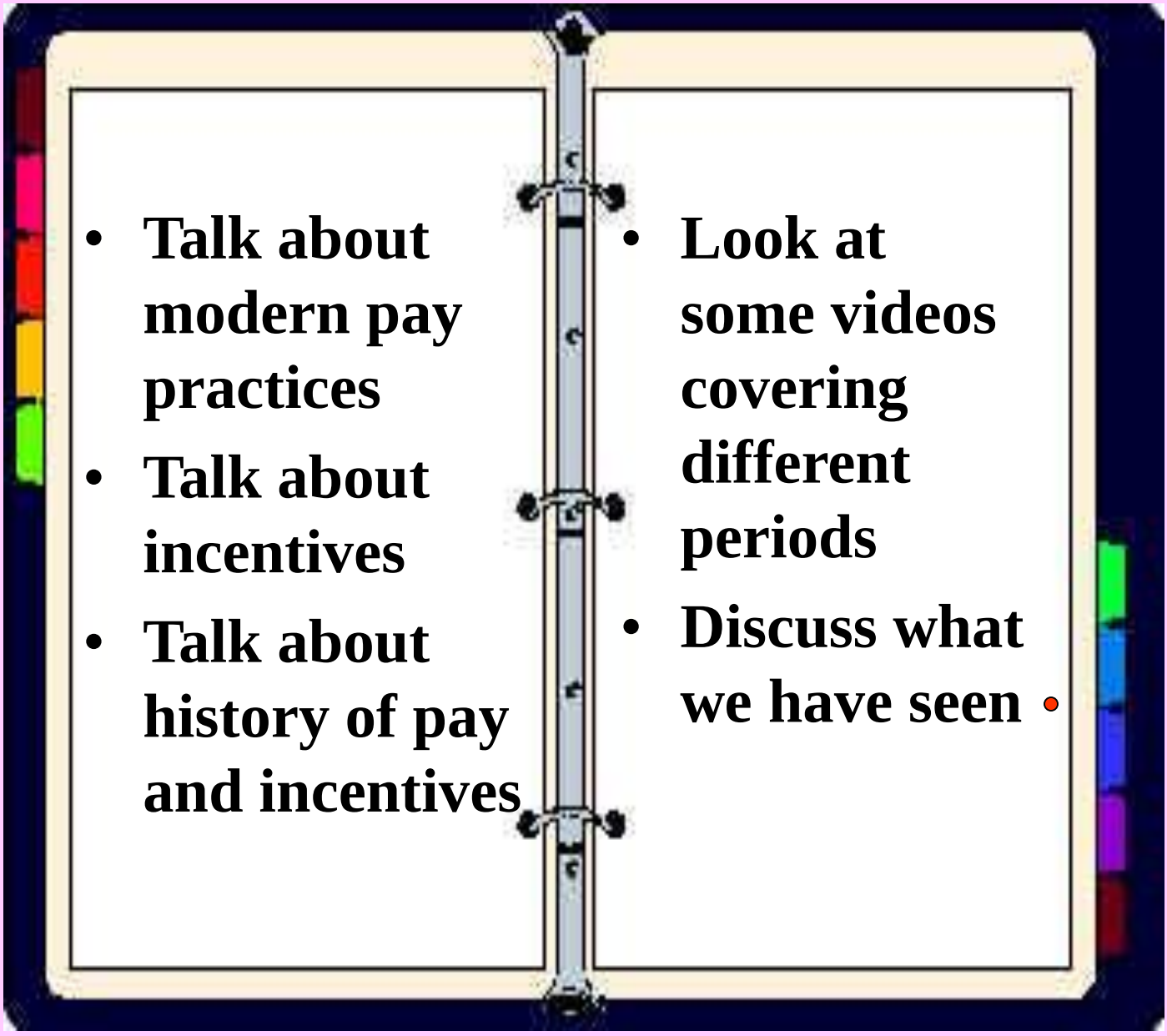
Today's Agenda



- **Talk about modern pay practices**
- **Talk about incentives**
- **Talk about history of pay and incentives**
- **Look at some videos covering different periods**
- **Discuss what we have seen**

"You ask me how we regulate wages; I can only reply that there is no idea in the modern social economy which at all corresponds with what was meant by wages in your day."

Edward Bellamy writing in 1887 in the novel *Looking Backwards* about a utopia in the year 2000

Bradbury Building, 1893

<u>Expectation</u>: ***Things change a lot over time.***

<u>Question</u>: ***Do they?***

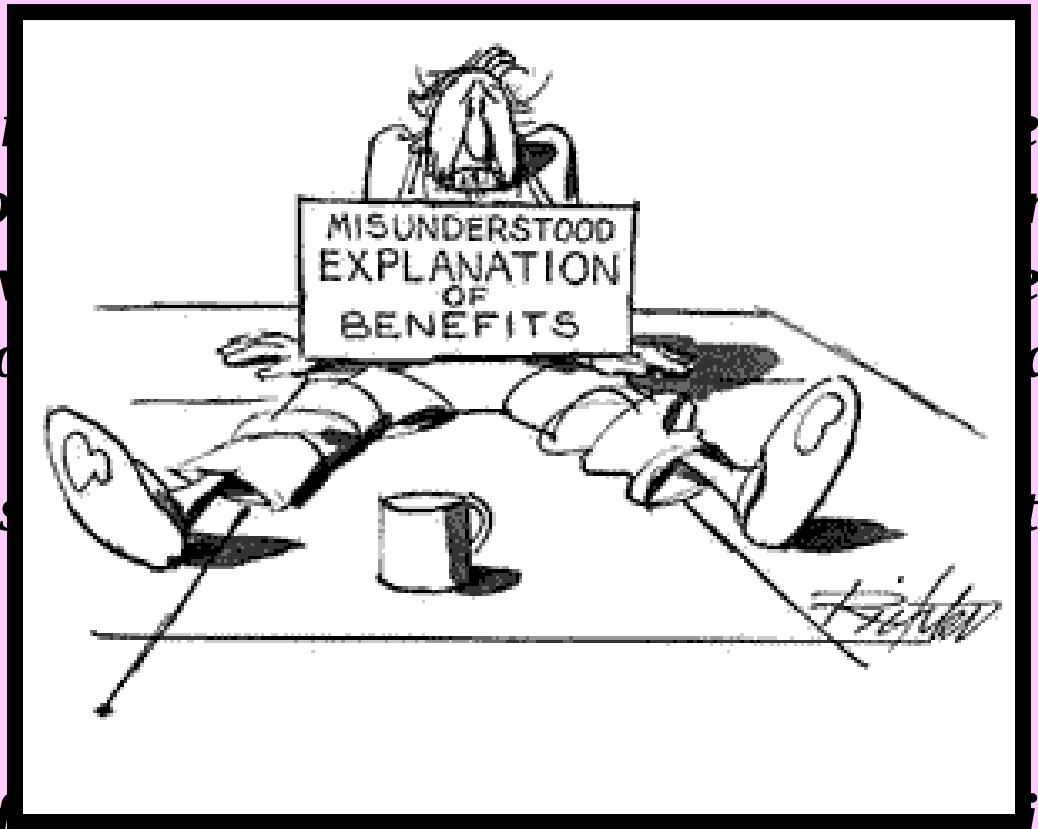
<u>Answer</u>: ***Yes and no.***

But there are changes over time!

"Under the present accounting standards, where surrendered shares are not 'mature,' the stock swap will be considered the functional equivalent of the cash settlement of a stock appreciation right, resulting in variable plan accounting treatment (the compensation expense will be estimated at the time of grant and adjusted in each subsequent accounting period to reflect changes in the fair market value of the company's stock) and ultimately the recognition of an expense equal to the difference between the option exercise price and the fair market value of the company's stock on the date of exercise."

"The Stock Options Book," 3rd ed., NCEO, 1999

"Under the present accounting standards, where surrendered shares are not 'mature,'



difference between the option exercise price and the fair market value of the company's stock on the date of exercise."

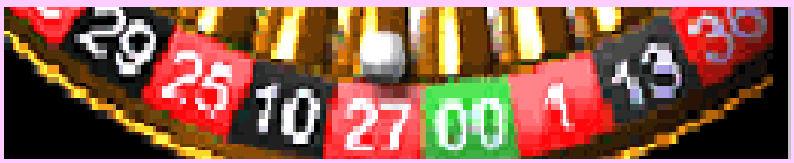
"The Stock Options Book," 3rd ed., NCEO, 1999

Defining Compensation

- **Time-based wages**
  - *Level*
  - *Structure*

- **Social welfare benefits**
  - *Pensions, health insurance*
  - *Publicly-provided or mandated benefits*

- **Individual and small group incentives**
- **Risk sharing plans**



ACCORDING TO THIS SURVEY THE COMPENSATION HERE IS "COMPETITIVE."
COMPETITIVE MEANS NOT THE HIGHEST. SO WE COULD GET PAID MORE IF WE WORKED AT ANOTHER COMPANY?
SHOULD WE CONTINUE WORKING AS HARD AS WE CAN OR SHOULD WE BACK OFF TO A MORE COMPETITIVE LEVEL?
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Even basic pay decisions can have behavioral effects

Social Welfare Benefits

- **Pensions, health insurance, etc.**
- **Often tax incentives**
- **Rigid in sense that do not vary with performance**
- **Can have anti-mobility effects**
  - ***"Job lock" with regard to health care and pre-existing ailments***
  - ***"Golden handcuffs" of defined-benefit pensions***

“There are no medical or pension benefits, but the employees’ lounge has excellent free coffee.”

Individual and Small Group Incentives

- **Piece rates**
  - *No incentive for cooperation*
  - *Promote waste*
  - *Employees can distort*

- **Elaborate "scientific management" systems**
- **Subjective systems such as merit bonuses based on performance appraisals**

Incentive Design Problem

Risk Sharing Plans

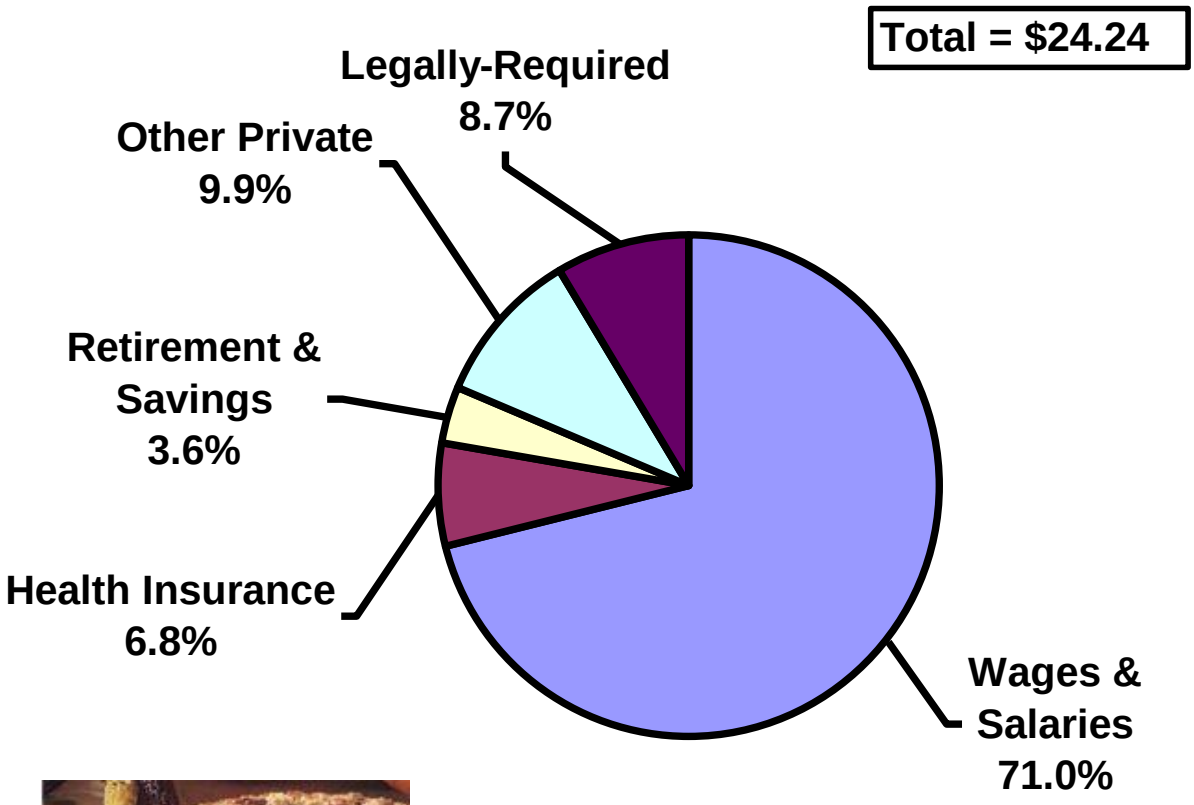
- **Profit sharing**
- **Gain sharing**
- **Employee stock ownership plans (ESOPs)**
- **Other forms of share ownership**
- **Stock options**
- **Classic 1/N problem if seen as incentive a.k.a. “free rider” problem**

Incentive fads come and go

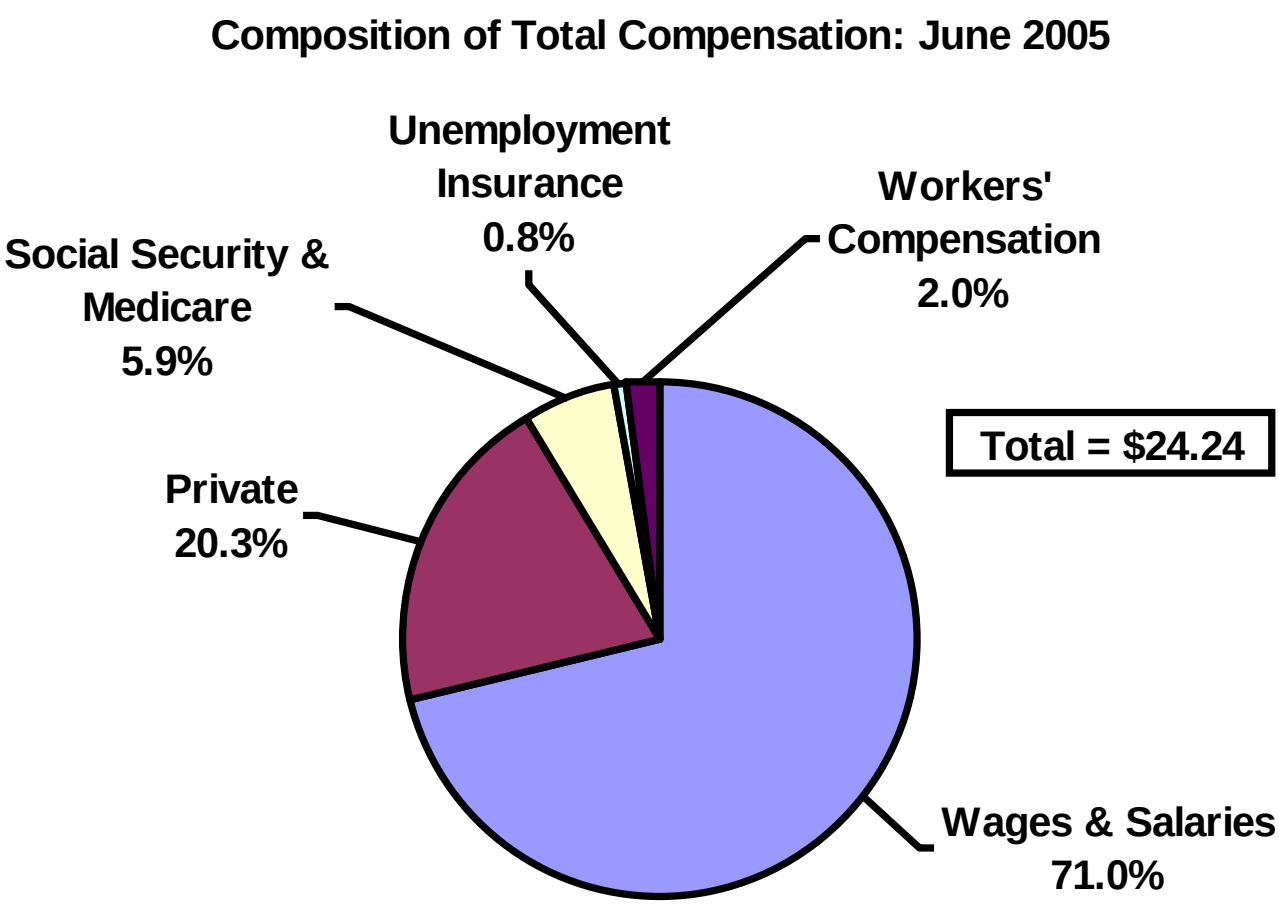
Dividing the Compensation "Pie"

Dividing the Compensation "Pie"

Composition of Private Compensation: June 2005



Dividing the Compensation "Pie"



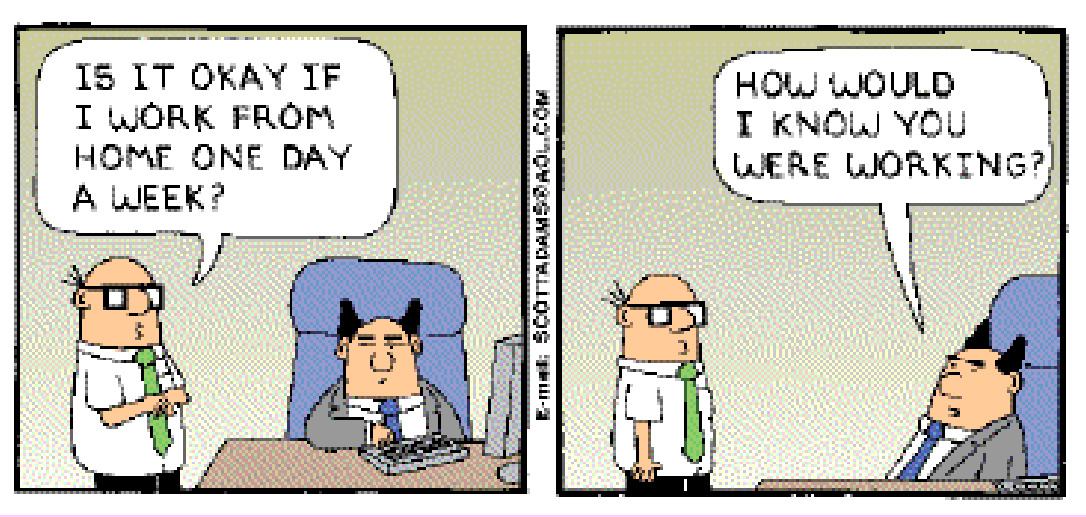
Alternative Pay Systems

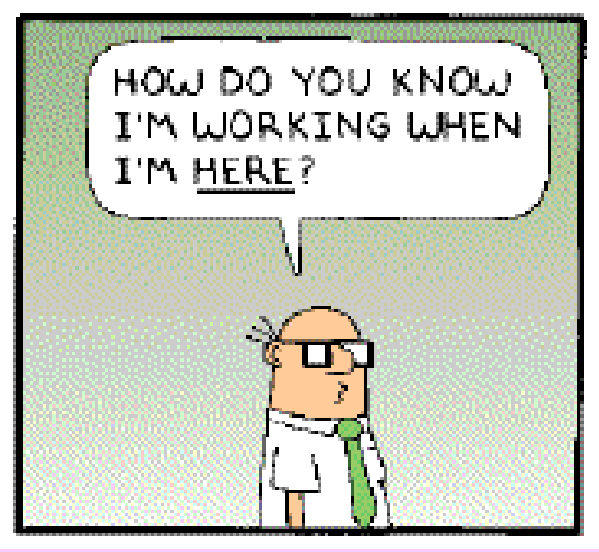
- **Piece rates**
  - **Mentioned in a fourth of union contracts**
- **Profit sharing**
  - **One third of Chamber of Commerce respondents**
  - **One eighth of full-time employees in govt. survey**
- **Gain sharing**
  - **Small, probably under 5%**
- **ESOPs**
  - **11% of Chamber of Commerce respondents**
  - **Under 4% of full-time employees in govt. survey**
- **Stock options**

Alternative Pay Systems

Stock options:

- 1.7% of non-executive employees in 1999
- Up from less than 0.5% in 1993
- 5.3% of employees in establishments with publicly-traded stock
  - One fifth of executives
  - 2% of employees making less than US$35,000
  - 27% of non-executives making > US$75,000

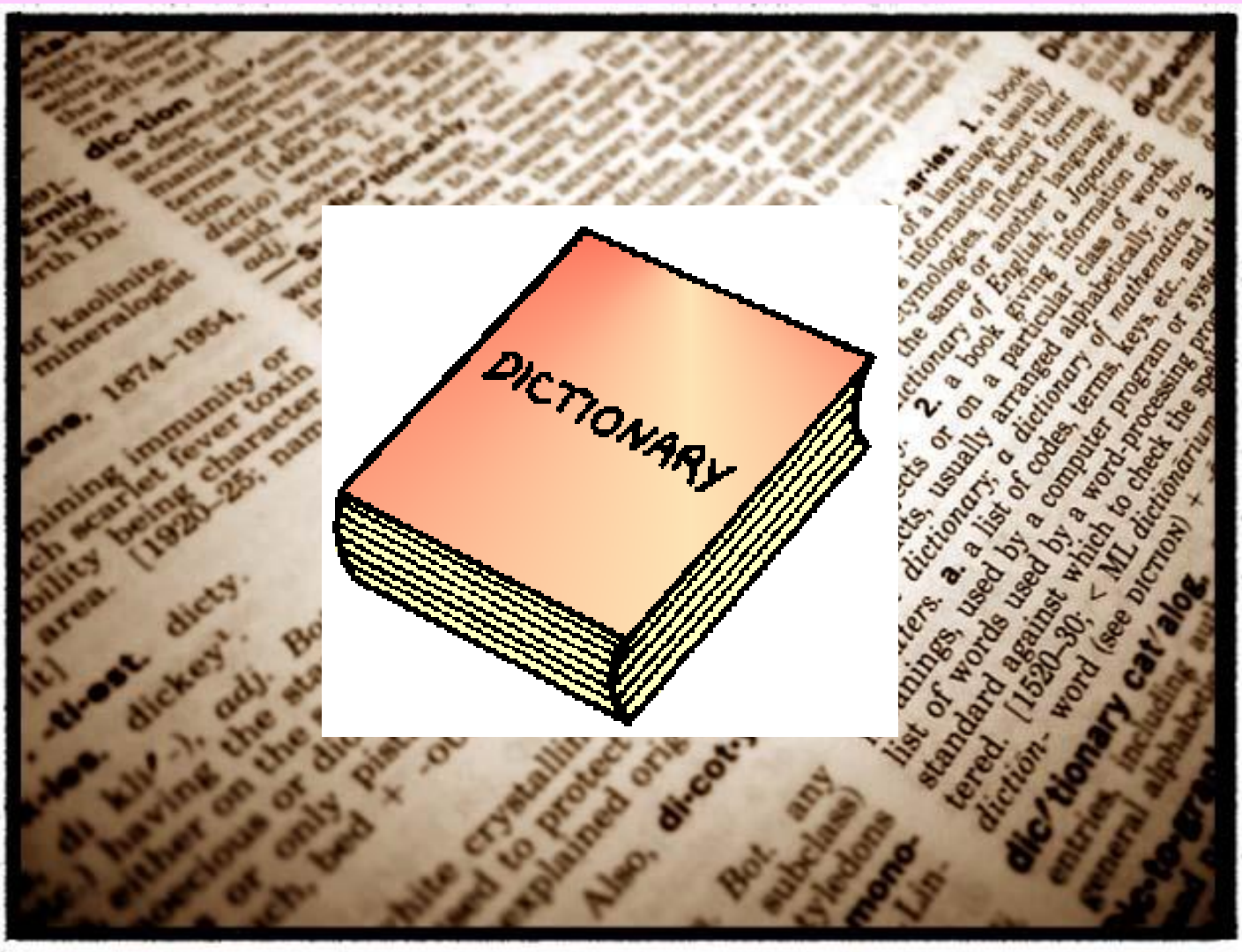




Principal/agent problem

The floggings will continue until morale improves.

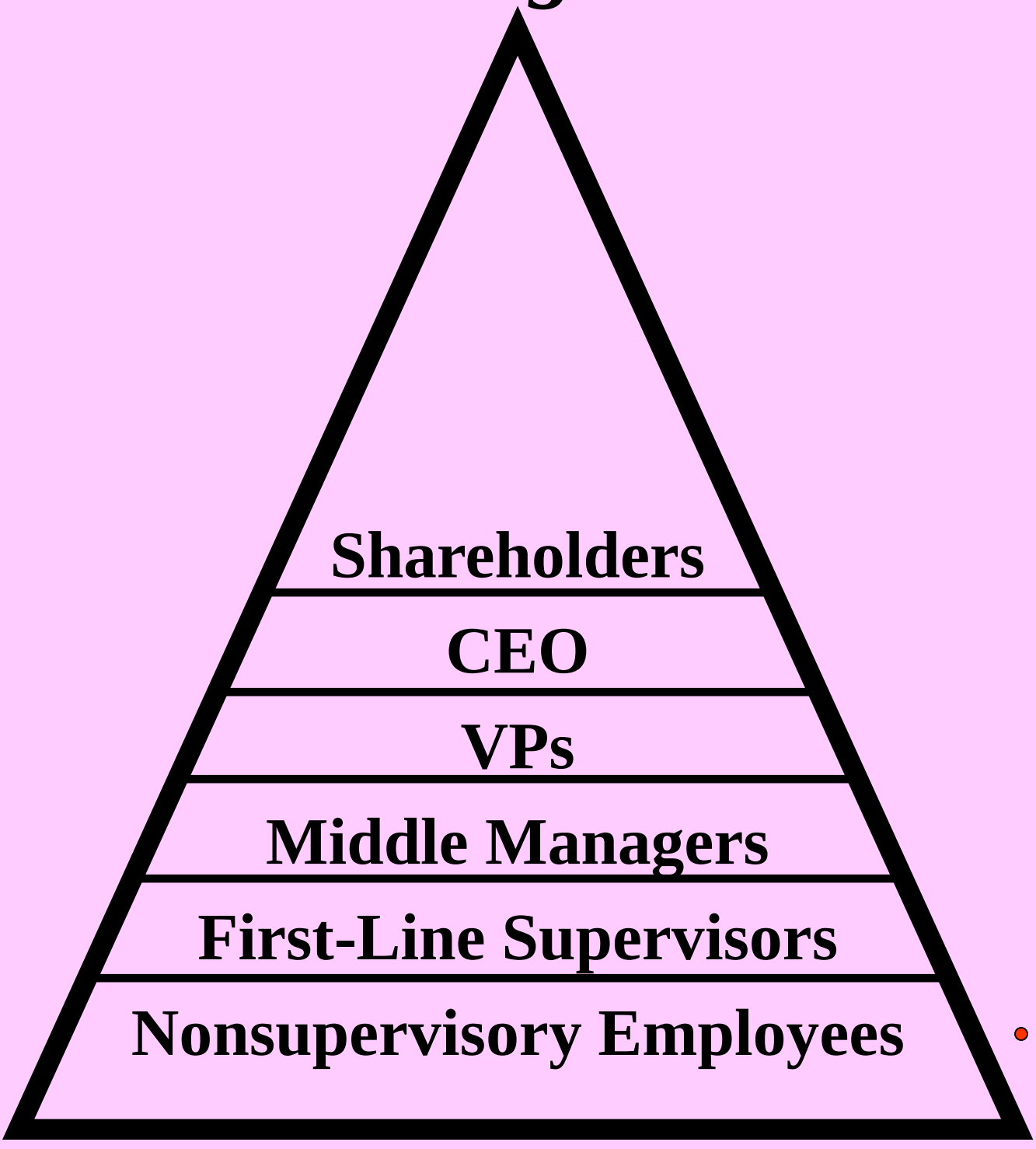
What does the word *“decimate”* mean?



What does the word *"decimate"* mean?

"Decimate" originally referred to the killing of every tenth person, a punishment used in the Roman army for mutinous legions.

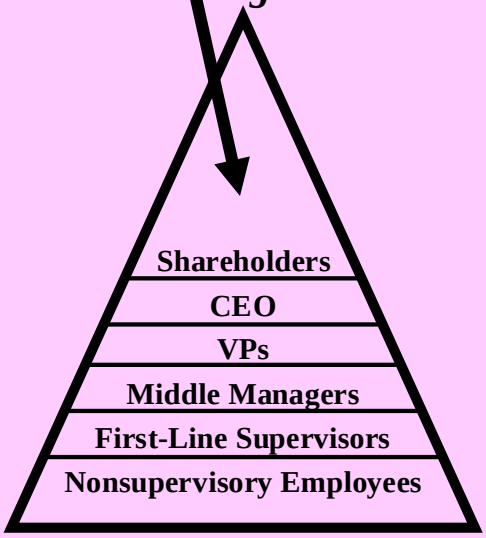
Hierarchy of Principals and Agents



Board Chair Kenneth Lay

CEO Jeff Skilling

Hierarchy of Principals and Agents



CFO Andrew Fastow

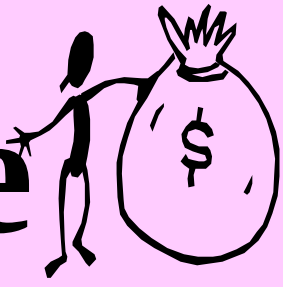
Skilling's mom on the principal/agent problem

"When you are the CEO and are on the Board of Directors, you are supposed to know what's going on with the rest of the company."

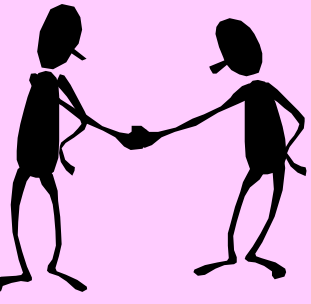
---Betty Skilling

How Do You Get the Help to Do What You Want?

- **Compensate**

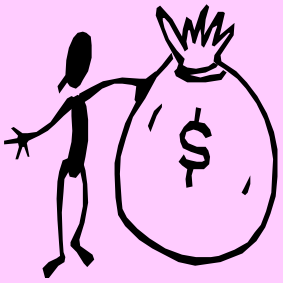


- **Motivate**

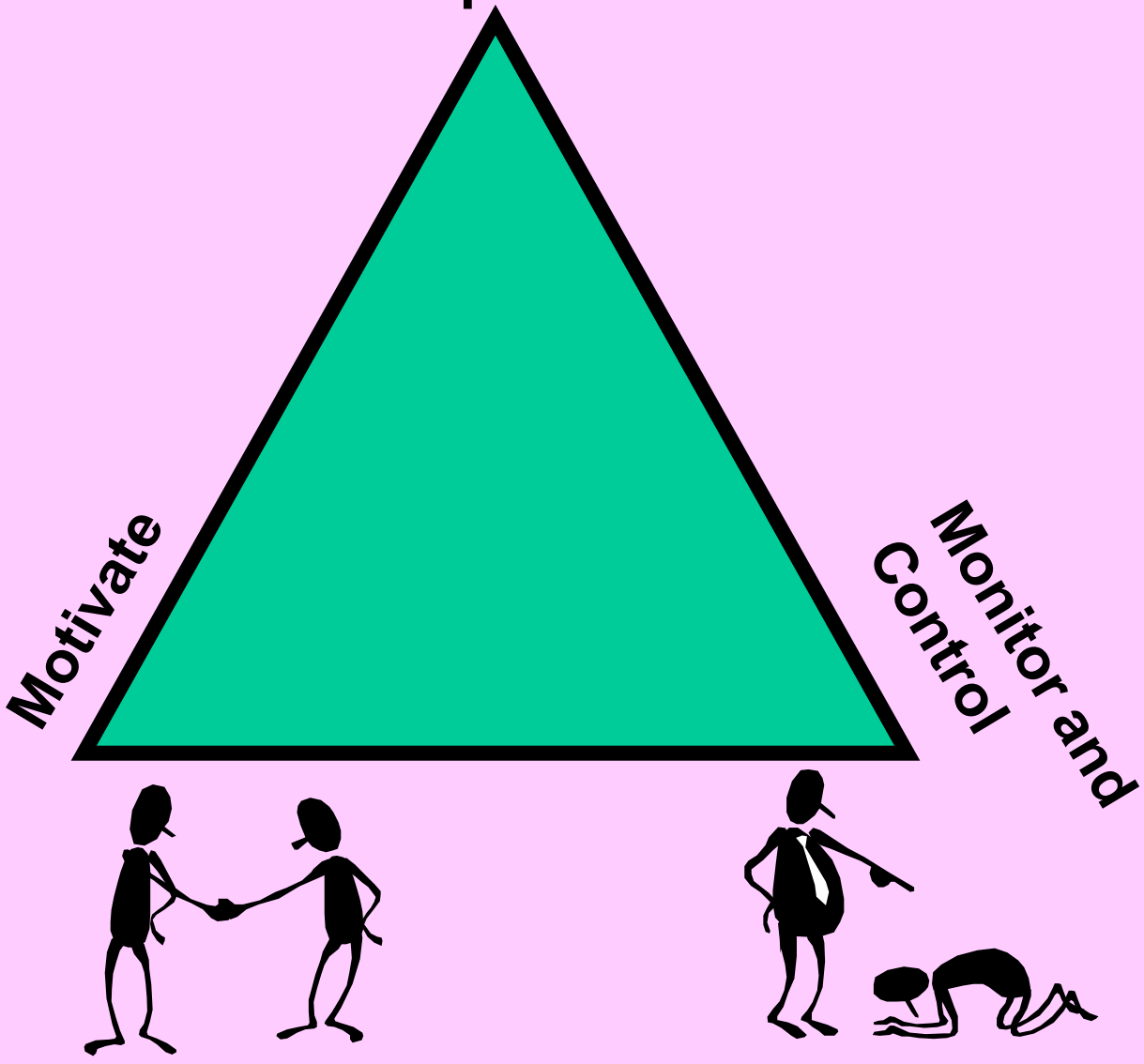


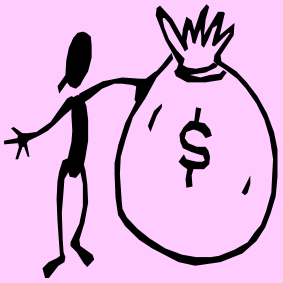
- **Monitor and Control**

Where Does the Enterprise End Up?



Compensate

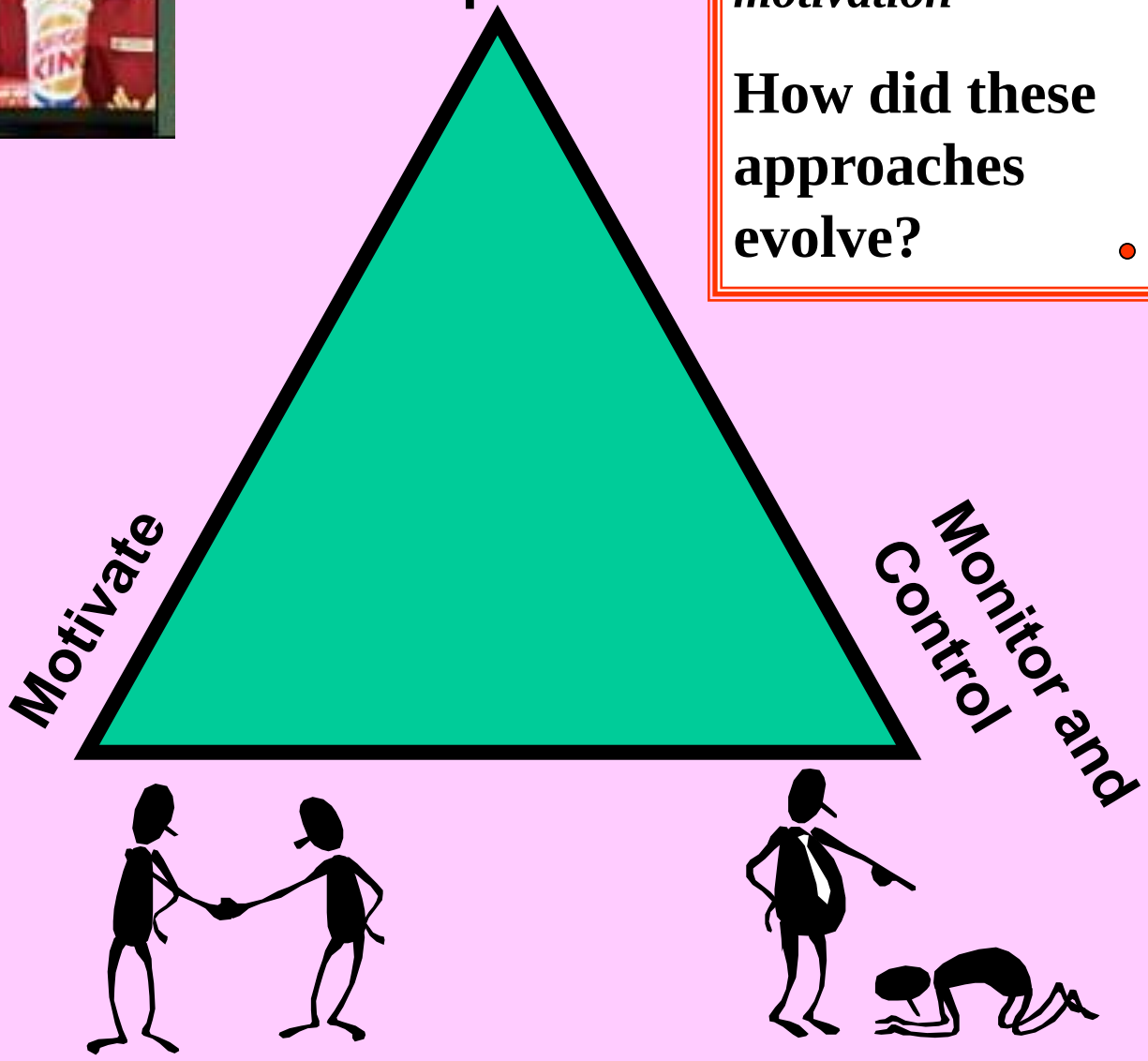




Where did UK Burger King end up?

- ***Pay level and incentive***
- ***Monitor time standards***
- ***Non-cash motivation***

How did these approaches evolve?



Historical Evolution: Pre-New Deal

- **Wage structure**

  Early development of job design (time & motion), job evaluation, and wage and salary administration through point systems

- **Social welfare benefits**

  Encouragement of employee thrift (predecessors to 401ks); some pensions, etc.

- **Incentives**

  Taylorist piece rates; some union resistance; efficiency wage idea (Ford)

Historical Evolution: Pre-New Deal

- **Risk sharing: stock ownership**
  - *Some large firms encouraged stock ownership as part of thrift plans*
  - *Seen as good PR aside from any incentive effect*
  - *Seen as inferior to piece rates but useful if piece rates could not be applied*
- **Risk sharing: profit sharing**
  - *Seen as inferior to piece rates but useful if piece rates could not be applied*

World War II

- **Emphasis on maximum wartime production**
- **Interest in use of incentives temporarily boosted by wartime goal**

Post-World War II

- **Impact of Depression Memories**
  - ***Stock ownership: "In some cases it was difficult to explain the situation to certain uneducated elements... who could not comprehend why they were not paid in full." (NICB)***
  - ***Profit sharing also disfavored***
  - ***Unions seek job/income security: GAW becomes SUB***
  - ***Unions seek role in wartime piece rate setting: use declines after war***
- **Emphasis on fairness, human relations, in wage setting**

  Wage and salary administration institutionalized

"O.K., if you can't see your way to giving me a pay raise, how about giving Parkerson a pay cut?"

"Fair" pay structure

Post-World War II

- **Social benefits: WW2 - 1980**
  - ***Greatly expanded offering of pensions, health insurance***
  - ***Union sector an initial center of such benefits***
  - ***Fit with emphasis on security***
  - ***Tend to tie workers to firm***
- **1980s and 90s: Union decline; pay for performance, erosion of social benefits, reduced job security**
- **Search for a "new" model for 21st century continues**

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